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Explicit Individual Contracting in the Labor Market

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The best known form of explicit contracting in the labor market is the collective bargaining agreement struck between organized workers and management. Despite the continuing decline of unionism and, consequently, collective bargaining in the United States, some 150,000 collective bargaining agreements covering roughly 11 million private-sector workers are presently in effect (Bureau of National Affairs 1991; Wafilewski 1992). Furthermore, data on collective bargaining contracts continue to be collected on a systematic basis, and thus it is possible to gauge the extent of such bargaining at a particular point in time and to observe changes over time.

In contrast, there are no recurring systematic data presently available concerning explicit individual contracting in the labor market. Anecdotal, popular, and case accounts of individual employment contracts (usually about conflicts over such contracts) surface from time to time, but these do not effectively substitute for systematic data by which one can determine the extent or changing incidence of explicit individual employment contracts.

Despite this data gap, and in part because of it, in this chapter I will analyze current and potential future uses of explicit individual employment contracting in the labor market. The first section of the chapter draws on the implicit contracting and psychological contracting literatures to derive a conceptual foundation for the analysis of explicit individual employment contracting. The second section broadens this foundation to incorporate concepts drawn from the human resource management and industrial relations literature, and presents new evidence and empirical analyses of explicit individual contracting in the labor market. In the third section I describe and

analyze selected case examples of explicit individual employment contracting in three U.S. firms, emphasizing the diversity of such contracting arrangements. The fourth section draws on this study's main conclusions to derive a forecast for the future of explicit individual contracting in the labor market.

Conceptual Foundations

The notion of implicit contracting in the labor market and in the employment relationship has been emphasized by economists and psychologists. Recent work by economists uses implicit contracting models to explain such phenomena as long-term employer-employee attachments, turnover, work effort, fringe benefits, variable compensation schemes, and employee voice mechanisms (Lazear 1992; Mitchell 1988; Ichniowski 1992; Kleiner 1992; Lewin and Mitchell 1992). In brief, this work begins with the stylized fact that it is often difficult for the employer to observe and monitor employee job performance. Therefore, employers are motivated to structure compensation schemes that pay workers less than the value of their marginal product early in their careers, and more than the value of their marginal product later in their careers. This in turn leads to upward-sloping age-earnings profiles for workers and long-term employer-employee attachments. Put differently, the upward-sloping age-earnings profile reflects the payment of efficiency wages by employers at individual points along the profile.

Under this arrangement workers are encouraged to monitor their own job performance, and workers whose performance is below target are encouraged to leave the firm — that is, to quit. But the central tendency under this implicit contracting arrangement is for workers to perform to targeted requirements (rather than shirk) and to remain in their jobs because later in their careers they will in effect receive pay premiums. Quitting early in their career means that workers will lose such premiums.

Employers also have a generalized incentive to keep turnover low due to the costs of recruitment, screening, hiring, and training, and because of the benefits they receive from paying wages below marginal product early in employees' careers. (Employers who attempt to discharge workers at the point at which pay just equals marginal product presumably will be dissuaded from doing so by the fact that information about such a practice will be efficiently traded in the labor market; the firm, having acquired a reputation for engaging in

this practice, will eventually be unable to attract workers.) However, employers also have a generalized incentive to encourage workers to leave the firm later in their career, when their pay premiums are the greatest. For this purpose, employers adopt fringe benefit plans that are typically backloaded (Mitchell 1992) — they provide the largest payouts for the last few years of service — and that are sometimes sweetened to encourage "early" retirement (Lazear 1979).

The concept of implicit contracting in the labor market can also be applied to the use of team or group incentives. Such incentives, especially in the form of profit-sharing and employee stock ownership plans for workers, have become widespread in the United States (Delaney, Lewin, and Ichniowski 1989). Basically, these plans reward employees based on team or group performance and do so after the fact — a form of payment for output as distinct from payment for input, which is in the form of salaries or wages. The possibility of such after-the-fact payments being made forms part of the implicit contract between the firm and the worker.

A major analytical issue in the area of team incentives involves motivation and the free rider problem. Why should an individual worker put forth the effort to perform to target when the efforts of others on the team will result in meeting the performance target? In other words, what is the motivation for the individual worker not to shirk under a team-based incentive plan? One answer is that the individual may know his or her coworkers well (perhaps even be related to them) or may feel a sense of altruism toward or identification with them. Programs of team-based employee involvement and participation in decision making are intended to strengthen such mutual identification. Another answer is that the team may engage in reciprocal monitoring to prevent shirking or to raise the cost to a worker of his or her failure to achieve the performance target. The Hawthorne experiments long ago showed that work groups can develop powerful norms supporting the achievement of organizational performance standards (Roethlisberger and Dickson 1939), and a more recent study of a U.S. paper mill showed how work groups strongly enforced production objectives under a newly introduced team concept of work organization (Ichniowski 1992). Such reciprocal monitoring within a work team appears to require some type of groupwide monetary incentive, such as a profit-sharing plan. Again, the use of reciprocal monitoring together with team incentives can be viewed as constituting some of the terms of the implicit contract between the employer and the employee.

The notion of a psychological contract between the employer and the employee has long been used by industrial and organizational

psychologists to refer to the set of expectations, beliefs, and attitudes that each party has with regard to the other (Schein 1980). Psychologists generally emphasize the importance of a proper match or fit between the parties' expectations, beliefs, and attitudes, and contend that mismatches along these dimensions of the employment relationship will result in dysfunctional consequences for the employee and the employer.

For example, following the Hawthorne experiments a stream of research explored the phenomenon of individual and work group restriction of output (Mathewson 1931; Roy 1952; Stagner 1956). Such behavior typically occurs in response to certain management actions, including unilateral changes in the organization of work, speedup of production processes, discharge of workers for cause, reductions in pay rates, and alterations of other terms and conditions of employment. Whatever their specific form, these and related management actions are sometimes judged by workers to violate the norms of their implicit psychological contracts with employers, hence the consequent restriction of output. In unionized settings, workers have sometimes responded to certain management actions by engaging in work slowdowns and strikes (that is, in particular forms of restriction of output); in these instances, workers judge management to have violated the terms of both explicit collective bargaining contracts and implicit psychological contracts (Kornhauser, Dubin, and Ross 1954; Karsh 1958).

More recently, studies of organizational entry have found that employee job performance and tenure are positively associated with "realistic" job previews, which provide job applicants with a balance of positive and negative organizational attributes and characteristics, in contrast to traditional job previews, which heavily emphasize positive organizational attributes and characteristics (Wanous 1992). The main conclusion of this research is that employees who enter an organization with a realistic picture of it are more likely than others to find the terms of their psychological contract with the organization actually met, leading to positive individual and organizational outcomes.

A plethora of research on employee absenteeism from and lateness to work finds that these behaviors are significantly associated with perceived violations of the norms of the psychological contract (Mobley 1982; Clegg 1983). Such violations, which may take many forms, apparently set off a sequential process of reduced employee commitment to the organization, hightened employee dissatisfaction with the organization, and increased employee withdrawal from the organization (Mowday, Porter, and Steers 1982; O'Reilly and

Chatman 1986). Moreover, employee withdrawal may proceed past the absenteeism and lateness stages to "voluntary" departure — that is, quitting — and several studies report significant negative associations between employee commitment and turnover, and between employee job satisfaction and turnover (Porter et al. 1974; Mobley 1982).

Even more recently, concepts of procedural justice, organization culture, and employee voice have been used to analyze employee attachment to and withdrawal from work organizations. The procedural justice literature focuses on the extent to which various organizational processes, especially the allocation of rewards, are judged by workers to meet expected standards of fairness. Perceived violations of such standards are associated with decreased employee commitment to and increased employee withdrawal from the firm (Sheppard, Lewicki, and Minton 1992). Similarly, organizations with strong cultures — that is, organizations whose members share common values and beliefs that are typically expressed in various rites, rituals, and symbols and that are systematically passed on to new members — are characterized by high employee commitment and low employee withdrawal (O'Reilly 1989; O'Reilly, Chatman, and Caldwell 1990). A strong organizational culture is widely regarded by researchers as a social control mechanism (O'Reilly 1989) and is often claimed to be a prerequisite for the successful introduction and implementation of team-building initiatives and broadened employee involvement and participation in decision making (Lawler 1986; Siehl and Martin 1990; Levine and Tyson 1990).

As to the concept of employee voice, most research in this area proceeds from Albert Hirschman's exit-voice-loyalty model, which posits that the exercise of voice will be negatively associated with exit (that is, withdrawal) behavior (Hirschman 1970). In the employment context, voice can be exercised through labor unions, grievance procedures, or both. While large-scale cross-sectional research shows that unionism is significantly negatively associated with employee quits, or exit (Freeman and Medoff 1984), longitudinal research on individual unionized and nonunion firms shows that the exercise of voice through grievance and grievance-like procedures is positively associated with voluntary and involuntary employee exit from the firm (Lewin and Peterson 1988; Lewin 1987a, 1992). Further, employee loyalty (a proxy for commitment) is significantly negatively associated with grievance filing (the exercise of voice) in the firm (Boroff and Lewin 1991; Lewin 1994). Indeed, evidence from this research also supports the conclusion that employees who exercise voice via grievance filing are likely to suffer reprisals for doing so —

which appears to constitute a violation of explicit contracts in unionized settings and implicit contracts in nonunion settings.

All of this research is consistent with, in fact embedded in, the older notion of a psychological contract between the employee and the employer. Concepts of procedural justice, organizational culture, and employee voice offer new insights into the dynamics and consequences of mismatches between employee and employer expectations, attitudes, and beliefs. In most settings, which is to say nonunion settings, these expectations, attitudes, and beliefs are part of implicit individual contracts between employers and employees. Given the large amount of attention that economists and psychologists have paid (from markedly different perspectives) to implicit individual contracting in the labor market, and perhaps especially given the evidence that the terms of such contracts can be and are transgressed, it is important to consider whether or not such implicit contracting will be supplanted by explicit contracting in the labor market.[1] Prior to doing so, however, I will examine the extent to which individual explicit labor market contracting is presently practiced in the United States.

Measuring and Modeling Explicit Contracts

As I have noted, systematic data on explicit individual labor market contracting in the United States are generally not available. However, a special survey of individual labor market contracting conducted in 1990 under the auspices of the University of California at Los Angeles (UCLA) Institute of Industrial Relations provides some relevant data in this regard. The survey was conducted among a sample of business units of publicly held U.S. firms listed in Standard and Poor's Compustat financial reporting file.[2]

As is shown in Table 15.1, among the 1,274 businesses that responded to the UCLA survey, about 31 percent use explicit individual contracts, which are typically referred to as employment contracts. The incidence of such contracts is greatest among professional employees, followed by managerial personnel, while manufacturing and financial service businesses practice individual employment contracting considerably more than do businesses in other industry categories. Explicit individual employment contracts are also more prevalent among unionized than nonunion businesses, younger than older businesses, smaller than larger businesses, and

multinational than domestic businesses.[3] A logit-type regression analysis of these data, which treated the aforementioned variables as structural characteristics of firms, showed that the incidence of explicit individual contracting differs significantly by occupation, industry, unionization, age of business, and geographical scope of business, but not by size of business.

Based on economic theorizing about implicit contracting in the labor market and behavioral science theorizing about the psychological contract in the employment relationship, a variety of factors other than the structural characteristics of firms may influence decisions by business organizations to adopt (or not adopt) explicit individual employment contracts. For example, businesses that use work teams may attempt to curb potential shirking and free-rider

Table 15.1. Incidence of explicit individual contracting, by firms' structural characteristics

Characteristics of firm	Explicit contracting	
	Yes (%)	No (%)
Total sample (N = 1,274)	31	69
Occupation		
Managerial	36	64
Professional	42	58
Clerical	14	86
Production	23	77
Unionization		
High unionization	37	63
Low unionization	28	72
Industry/sector		
Agriculture, mining, construction	13	87
Manufacturing	43	57
Transportation, communications, public utilities	27	73
Wholesale and retail trade	21	79
Finance, insurance, real estate	39	61
Services	28	72
Firm size		
Large	30	70
Small	33	67
Firm age		
Old	27	73
Young	37	63
Geographic scope		
Multinational firm	39	61
Domestic firm	27	73

Source: UCLA Institute of Industrial Relations Explicit Contracting Survey, 1990.

problems, and to strengthen the motivational basis of teamwork, by practicing explicit individual contracting. Similarly, businesses that use variable pay arrangements for employees — for example, gain sharing, profit sharing, bonus, stock option, or stock ownership plans — may be especially likely to practice explicit individual contracting to formalize and underscore the potential financial gains to employees from achieving specified performance goals.

The rapidly growing literature on human resource management suggests still other factors that may affect the incidence of explicit individual employment contracting. Various subsets of this literature provide theoretical or empirical support for the positive influences of employee information-sharing programs, flexible job design programs, employee training programs, and targeted, validated selection practices on firm performance (Kleiner and Bouillon 1988; Morishima 1991; Katz and Keffe 1990; Osterman 1988; Mangum, Mangum and Hansen 1990; Fossum 1990; Hunter and Schmidt 1982; Arvey and Faley 1988). Businesses that have adopted such practices may also be likely to practice explicit individual contracting as a way of "binding" employees to the firm and raising the probability of realizing "returns" on these new initiatives.

Another subset of the human resource management literature emphasizes the linkages between a business's human resource policies and practices and its overall strategy — so-called strategic human resource management. Ostensibly, the stronger this linkage, the more likely that human resource policies and practices will contribute to the performance of the business (Kochan, Katz, and McKersie 1986; Kleiner et al. 1987; Lewin 1987b). One empirical measure of this linkage is the extent to which a business's senior human resource official is involved in the strategic planning process (Delaney, Lewin, and Ichniowski 1989; Lewin and Mitchell 1992). For purposes of this chapter, it is suggested that businesses with a "strong" link between human resource management strategy and business strategy are especially likely to practice explicit individual employment contracting, in part as a way of strengthening this linkage and in part to reflect the concept embedded in this linkage, that human resources are assets in which current investments yield future returns (Strober 1990; Flamholtz 1985).

From the aforementioned literature in procedural justice, organizational culture, and employee voice, it is possible to derive the proposition that businesses with formal systems of dispute resolution — grievance and grievance-like procedures — will be more likely than businesses without such systems to practice explicit individual employment contracting. The presence of a formal dis-

pute resolution system in a business indicates that certain expectations and beliefs about the employment relationship have gone beyond the informal shared-values stage to the explicit codification stage. Thus, a logical next step may be to codify certain other dimensions of the employment relationship in explicit individual contracts. Additionally, however, businesses that have been charged with race, sex, or age discrimination by current or former employees, or with wrongful termination by former employees, are more likely to engage in explicit individual contracting than businesses that have not been so charged.

The UCLA survey elicited data on financial and nonfinancial participation programs, information sharing, flexible job design, training programs, selection practices, grievance systems, and discrimination and wrongful termination activity in the responding businesses, thereby making it possible to test for the effects of these variables on the use of explicit individual employment contracting. Table 15.2 presents descriptive statistics for this set of variables, and Table 15.3 presents the results of regression analyses in which the incidence of explicit individual employment contracting among the firms that responded to the UCLA survey served as the dependent variable.

The data in Table 15.2 suggest that the incidence of explicit individual employment contracting varies markedly by the human resource management characteristics of firms. Specifically, the incidence of explicit individual contracting varies positively with firms' use of financial participation, information sharing, and employee training programs as well as with selection test validation, senior human resource executive involvement in business planning, formal grievance procedures, and experience with employment discrimination and wrongful discharge litigation. By contrast, the incidence of explicit individual contracting varies negatively with firms' use of employee nonfinancial participation programs and flexible job design programs.

The regression results presented in Table 15.3 refine and extend these findings.[4] Firms with employee financial participation (FP), information sharing (IS), and formal training (TRAIN) programs, and those that have experienced employment discrimination or wrongful termination litigation (DISC), are significantly more likely to practice explicit individual employment contracting than are firms without such characteristics (column 2). The validation of selection tests (VALID), use of grievance procedures (GP), and involvement of senior human resource officials in business planning (HRI) are positively but not significantly related to the incidence of explicit employment contracting, while programs of employee nonfinancial participation

(NFP) and flexible job design (FJD) are negatively but not significantly related to the incidence of explicit contracting. Moreover, these findings generally hold when selected firm structural characteristics are included in the regression analysis (column 3).[5]

The dichotomous (yes-no) dependent variable used to this point does not capture the scope of explicit individual employment contracting in two respects: the proportion of a firm's work force that is covered by such contracts, and the terms and conditions of employ-

Table 15.2. Relationships between incidence of explicit individual contracting and firms' human resource management characteristics

Human resource management characteristics	Incidence of explicit individual contracting (%)
Employee financial participation program (FP)	
Yes	36
No	26
Employee nonfinancial participation program (NFP)	
Yes	29
No	33
Information sharing program (IS)	
Yes	35
No	27
Flexible job design program (FJD)	
Yes	29
No	32
Employee training program (TRAIN)	
Yes	35
No	27
Employee selection test validation (VALID)	
Yes	34
No	28
Human resource executive involved in business planning (HRI)	
Yes	35
No	28
Formal grievance procedure (GP)	
Yes	33
No	30
Employment discrimination/wrongful termination litigation (DISC)	
Yes	37
No	27

Source: UCLA Institute of Industrial Relations Explicit Contracting Survey, 1990. Total number of cases: 1,068.

Table 15.3. Regression estimates of the incidence of explicit individual contracting (t-values in parentheses)

1	2	3
Independent variable	Dependent variable	
	Explicit contracting	Explicit contracting
Constant	3.03	2.87
	(2.04)	(1.95)
FP	2.64*	2.45*
	(1.23)	(1.12)
NFP	−0.63	−0.59
	(−0.42)	(−0.38)
IS	1.92*	1.77*
	(0.91)	(0.84)
FJD	−0.44	−0.40
	(−0.30)	(−0.28)
TRAIN	1.83*	1.69*
	(0.87)	(0.81)
VALID	1.23	1.17
	(0.88)	(0.79)
HRI	1.42	1.31
	(1.02)	(0.94)
GP	1.27	1.19
	(0.78)	(0.71)
DISC	2.23**	2.11**
	(0.92)	(0.85)
Proportion of managerial and professional employees (MGR-PROF)	—	1.58*
		(0.73)
Firm in manufacturing or financial services sector (MFG-FIRE)	—	1.83*
		(0.87)
Firm operates outside U.S. (MNC)	—	1.54*
		(0.71)
Percent of workers unionized (UNION)	—	1.02
		(0.69)
R^2	.28	.33
Number of cases	1,042	1,016

* Significant at $p = < .05$.
** Significant at $p = < .01$.

ment that are covered by such contracts.[6] The UCLA survey provided direct data on (estimates of) respondent firms' employee coverage by explicit contracts, and these were used to test scope-of-coverage regression equations, the results of which are reported in Table 15.4. Several individual questions included in the UCLA sur-

Table 15.4 Regression estimates of percent of employees covered by explicit individual contracts (t-values in parentheses)

1	2	3
Independent variable	Dependent variable	
	% of Employees covered	% of Employees covered
Constant	2.67	2.45
	(2.13)	(1.93)
FP	2.56*	2.32*
	(1.23)	(1.13)
NFP	−2.36*	−2.15*
	(−1.09)	(−1.04)
IS	2.04*	1.92*
	(0.93)	(0.86)
FJD	−2.01*	−1.87*
	(−0.91)	(−0.90)
TRAIN	1.96*	1.79*
	(0.92)	(0.85)
VALID	0.82	0.76
	(0.59)	(0.55)
HRI	1.30	1.21
	(0.82)	(0.79)
GP	0.99	0.97
	(0.65)	(0.64)
DISC	2.39**	2.16**
	(0.98)	(0.89)
MGR-PROF	—	1.64*
		(0.73)
MFG-FIRE	—	1.82*
		(0.81)
MNC	—	1.73*
		(0.84)
UNION	—	1.18
		(0.76)
R^2	.34	.39
Number of cases	327	323

Note: Based on data for firms with explicit individual contracts.
* Significant at $p = < .05$.
** Significant at $p = < .01$.

vey were used to construct a terms-and-conditions scope-of-coverage variable (index), and responses to these questions served as the data for testing the relevant regressions equations, the results of which are reported in Table 15.5.[7]

From Table 15.4 it can be observed that, as with the incidence of explicit individual contracting, the proportion of a firm's employees covered by explicit individual contracts is significantly positively associated with several human resource management characteristics of firms: the use of financial participation, information sharing, and formal training programs, and experience with discrimination or wrongful termination litigation (column 2). Several structural characteristics of firms are also positively associated with the proportion of employees covered by explicit contracts, namely, the proportion of managerial and professional employees in the firm (MGR-PROF), presence of the firm in the manufacturing or financial services sector (MFG-FIRE) and the extent to which a firm operates outside of the United States (MNC) (column 3).[8] The use of nonfinancial participation and flexible job design programs are significantly negatively associated with the proportion of a firm's employees covered by explicit individual contracts. On balance, then, the incidence of explicit individual contracts and the percentage of a firm's employees covered by such contracts are for the most part influenced by common human resource management and structural variables.

The findings reported in Tables 15.3 and 15.4 for the financial participation (FP), nonfinancial participation (NFP), and flexible job design (FJD) variables are especially notable, not only because the signs on the coefficients of NFP and FJD are opposite of those that were predicted (that is, they are negative rather than positive), but also because of the recent emphasis in U.S. business on rethinking the ways in which work is organized and employees are utilized and rewarded. Initiatives to enhance the flexibility of work arrangements, to involve employees more fully in workplace and organizational decision making, and to increase the relative proportion of variable pay (or pay at risk) in the compensation package have become widespread in recent years (Delaney, Lewin, and Ichniowski 1989; Kochan, Katz, and McKersie 1986). Yet apparently only the last of these initiatives is positively associated with the use of explicit individual contracting in the labor market. When it comes to designing more flexible jobs and involving employees more fully in decision making via programs of nonfinancial participation, employers seemingly prefer to treat these arrangements as part of implicit contracts with employees.

Somewhat different dynamics, however, are at work with respect

to the scope of terms and conditions included in explict individual contracts, as is evident from the regression results presented in Table 15.5. They show that the scope of coverage is significantly negatively associated with the use of financial *and* nonfinancial participation programs, information sharing programs, and the presence of griev-

Table 15.5. Regression estimates of scope of terms and conditions covered by explicit individual contracts (t-values in parentheses)

1	2	3
	Dependent variable	
Independent variable	Scope of terms and conditions	Scope of terms and conditions
Constant	2.38	2.19
	(1.94)	(1.82)
FP	−2.17*	−2.06*
	(−0.96)	(−0.92)
NFP	−2.31*	−2.16*
	(−1.04)	(−0.95)
IS	−1.98*	−1.89*
	(−0.91)	(−0.87)
FSD	−1.15	−1.09
	(0.79)	(−0.76)
TRAIN	−0.81	−0.76
	(−0.59)	(−0.57)
VALID	0.50	0.46
	(0.36)	(0.34)
HRI	1.73*	1.61*
	(0.83)	(0.72)
GP	−1.87*	−1.76*
	(−0.89)	(−0.82)
DISC	1.04	0.96
	(0.71)	(0.69)
MGR-PROF	0.87	0.81
	(0.60)	(0.58)
MFG-FIRE	1.77*	1.68*
	(0.82)	(0.77)
MNC	0.73	0.67
	(0.48)	(0.45)
UNION	1.62*	1.54*
	(0.73)	(0.70)
R^2	.31	.35
Number of cases	324	311

Note: Based on data for firms with explicit individual contracts.
* Significant at $p = < .05$.

ance procedures, and significantly positively associated with senior human resource executive involvement in business planning, presence of the firm in the manufacturing or financial services sector (MFG-FIRE), and the percentage of the firm's work force that is unionized (UNION) (columns 2 and 3). Recall that financial participation and information sharing programs were previously found to be significantly positively related to the incidence of explicit individual contracts and to the proportion of a firm's employees covered by such contracts. Further, the firm's use of formal training programs and its experience with discrimination or wrongful termination litigation, which were also significantly related (in opposite directions) to the incidence of explicit individual contracts and to the proportion of a firm's employees covered by such contracts, are not significantly related to the scope of terms and conditions included in explicit individual contracts. Hence, the scope of terms and conditions included in explicit individual contracts in U.S. firms is apparently subject to a somewhat different set of determinants from those that influence the incidence of and proportion of employees covered by explicit contracts.

Case Examples of Explicit Individual Contracting

Among the specific terms and conditions covered by explicit individual contracts in the firms that responded to the UCLA survey, the most prevalent were those pertaining to employee access to so-called trade secrets.[9] The typical contract provision requires the employee to agree not to reveal trade secrets of the firm to competitors during and (for a specified period) following the employee's tenure with the firm. In return, the employee is given access to these trade secrets that are sometimes associated with an upgrading or promotion of the employee and, more broadly, with continuity of employment.

The most common trade secrets in this regard take the form of components of the production process in manufacturing firms and lists of customers or clients in service firms. Other trade secrets pertain to customer credit ratings, supplier-vendor financial information, inventory valuation, computer programs, and security procedures. Provisions for and restrictions on employee use of trade secrets are most often found in explicit individual contracts with professional personnel — notably scientists and engineers — and appear to be most prevalent among firms that serve as defense

contractors and subcontractors. Nevertheless, clerical and production employees are also sometimes parties to explicit individual contracts that contain trade secret provisions.

Explicit individual employment contracts for executive and managerial personnel sometimes contain provisions barring such personnel from revealing the firm's strategic planning process and written business plans to competitors during and following the executive or manager's tenure with the firm. Such contracts also often contain language restricting the executive or manager for a specified time period from opening or joining a business that is a direct competitor of the firm in question. Provisions pertaining to personal nonwork behavior are also more prevalent in explicit individual contracts with managerial than with nonmanagerial personnel, according to the UCLA data.[10]

To better illustrate the uses to which explicit individual contracts are presently being put by U.S. firms, I will briefly consider three examples of such contracts, one in an aerospace firm, another in a financial services firm, and the last in a hotel and restaurant firm. To preserve confidentiality, the firms are referred to below as Firm A, Firm F, and Firm H, respectively. The data for this comparison were obtained from site visits, field interviews, and archival analysis in three firms that were among those that responded to the 1990 UCLA survey and that subsequently agreed to participate in this phase of the study.[11]

Firm A

This large aerospace firm produces aircraft, aircraft components, and a wide variety of other aviation products, largely for the U.S. Air Force. As of 1990, some 80 percent of its business was done under contract with the Department of Defense. About 75 percent of the firm's 36,000-member work force has signed explicit individual employment contracts, and this proportion rises to almost 100 percent for the firm's managerial and professional employees.

Virtually all of these explicit individual contracts contain a trade secrets provision, which reads in part as follows:

> As a condition of continued employment with [Firm A], the employee agrees not to reveal to competitors, suppliers, or employees of other units of [Firm A] information about [Firm A's] products, production processes and components, subcontractors, inventories, accounting methods, and financial reports. Violation of this provision will result in disciplinary action by [Firm A], including possible termination of employment.

The written contract containing this and other provisions is proferred to the job applicant in the late stages of the employment-selection process, that is, just prior to hiring. Failure of the job applicant to sign the contract will result in the applicant's not being hired by Firm A. According to the personnel data supplied by this firm for the period from 1986 to 1990, about 2 percent of job applicants who make it through the employment-selection process to this stage refuse to sign explicit individual employment contracts. Also during this period, four cases of individuals who violated the trade secrets provision of their explicit contracts with Firm A were discovered, and all four cases resulted in termination from the firm.

For senior executive and managerial personnel of Firm A, explicit individual contracts contain the following provision:

> As a condition of continued employment with [Firm A], the employee agrees not to reveal to competitors, suppliers, government officials, or employees of other units of [Firm A] information about [Firm A's] business plans, business strategy, or customers. Violation of this provision will result in disciplinary action by [Firm A], including possible termination of employment. Further, upon separation from [Firm A], the employee agrees not to seek employment with or become employed with a competitor company for a period of three years following such separation. Violation of this provision will result in legal action by [Firm A] against the former employee.

Employee agreement to these provisions is required for the employee to be placed in a senior executive or managerial position with Firm A. According to personnel data supplied by this firm for the period from 1986 to 1990, during which time Firm A made 34 appointments to senior executive and managerial positions, three individuals refused to sign explicit individual contracts containing the provisions shown above. Further, during this same period two senior executives who left the firm went to work for competitors of Firm A, which subsequently brought legal action against them. One of these executives then left his new employer, and the other was dismissed by his new employer upon receipt of notice of Firm A's legal action.

Firm F

This financial services firm provides investment banking, personal banking, brokerage, and related services to a mix of corporate, business, and individual clients. Approximately 80 percent of its 2,400-member work force has signed explicit individual employment contracts, and this proportion rises to 100 percent for professional

personnel (for example, investment bankers and stock brokers) and senior executives. The explicit contracts used by this firm are lengthy and cover such matters as trade secrets, fiduciary responsibilities, and treatment of customers. In addition, however, these contracts specify the compensation arrangement between individual employees and firm and are "renegotiated" annually. An example of the compensation provision of one such explicit contract reads as follows:

> During 1989, [the employee] will be paid a salary of $112,000.00 by [Firm F]. [The employee] will be eligible to participate in the 1989 bonus pool provided that he remains continuously employed with [Firm F] during 1989. The bonus pool will provide [the employee] with no less than four percent of his base salary, and may reach up [*sic*] to 20 percent depending upon the certified 1989 financial results for [Firm F]. The determination of the size of the bonus pool and its allocation among members of [Firm F] will be at the discretion of the Management Committee."

Beginning in 1986, Firm F expanded the provisions of its explicit contracts with individual employees to encompass certain aspects of personal behavior, especially in the area of substance abuse. Selected provisions of this new "standard contract" read as follows:

> As a condition of employment with [Firm F], the employee agrees not to use illegal substances, including drugs. Upon discovery by [Firm F] of the use of such substances by an employee, the employee will be dismissed and referral may be made to proper authorities for subsequent legal action.
>
> As a condition of employment with [Firm F], the employee agrees to submit to tests for substance and chemical dependency. The results of such tests, including the bodily fluids extracted from the employee, will remain the property of [Firm F].
>
> [Firm F] retains the right to make known to proper authorities and inquiring commercial enterprises the results of tests for chemical and substance dependency performed on the employee. The employee agrees to waive his right to bring legal action against [Firm F] in the event that such test results are made known to government authorities, commercial enterprises, or other inquiring organizations and parties.

As with Firm A, Firm F presents explicit individual contracts containing these and other provisions to job applicants late in the

employment-selection process, just prior to hiring. According to personnel data provided by Firm F for the period from 1986 to 1990, approximately 24 percent of job applicants to managerial and professional positions who made it through the early stages of the employment-selection process refused to sign explicit contracts proferred to them by the firm. Also during this period, some 3.5 percent of Firm F's employees were dismissed for violating one or another provision of their explicit contracts with the firm.

Firm H

This firm is in the hotel and restaurant business and operates more than 1,000 such establishments in the United States and abroad. It has about 160,000 employees worldwide, of whom approximately 80 percent work in the United States. Historically, Firm H has had high employee turnover rates, averaging 100 percent annually across various occupational specialties, and approaching 400 percent annually for jobs such as desk clerk, reservations agent, and bell captain. Historically as well, Firm H has maintained explicit individual employment contracts only for a few senior executives and certain security personnel.

Beginning in 1988, however, Firm H decided to adopt explicit individual contracting for a variety of hotel and restaurant personnel at selected locations. The rationale for this decision was that such contracting would help reduce employee turnover, lengthen employee job tenure, and enable Firm H to secure a larger (and more certain) return on its investment in employee training. Such training was deemed necessary to bring new employees up to "threshold" levels of reading, writing, computing, and customer relations skills, but the problem for the firm was that it had little or no way to ensure that new employees would remain with the firm long enough to permit the training to, in effect, pay off. Explicit contracting was judged by Firm H's senior management, especially its senior human resources executives, to be a partial solution to this problem. In addition, achievement of these human resource objectives was considered critical to achieving a key business objective, namely, increased customer satisfaction.

The explicit contract offered by Firm H to prospective employees (in selected locations) contains the following provision:

> As a condition of employment with [Firm H], [the employee] agrees to participate in company-provided training which will begin immediately upon [the employee's] hiring by [Firm H] and which will last for three weeks. Following successful

> completion of the training program, [the employee] will receive a six percent base pay increase and a full-time work assignment. Following six months of satisfactory performance in this work assignment, [the employee] will receive a five percent increase in base pay. [The employee] agrees to remain employed with [Firm H] for 15 months from today, at which time [Firm H] and [the employee] will jointly decide if the employment relationship shall be continued.

Other provisions of this explicit contract and other policies of Firm H allow the employment relationship to be ended by either party earlier than specified in the contract.[12] Data provided by Firm H for the period from 1989 to 1990 indicate that approximately 4 percent of job applicants to whom offers of employment were made rejected the offers because of unwillingness to sign explicit employment contracts. Further, some 6 percent of employees hired during this period left their employment prior to the ending dates specified in their explicit contracts with Firm H. But these data also showed that Firm H's hotel and restaurant establishments that used explicit individual employment contracts had lower average employee turnover rates, longer average employee job tenure, and higher (measured) levels of customer satisfaction than establishments that did not use such contracting arrangements. Largely on the basis of these findings, Firm H decided in 1991 to extend the use of explicit employment contracting, from about 20 percent to 40 percent of its hotels and restaurants in the United States.

As the examples provided by Firms A, F, and H indicate, there is no uniform or perhaps even standard type of explicit individual employment contract presently prevailing in the U.S. labor market. This is in contrast to the uniformity of contracts that develop under collective bargaining between unions and employers, and apparently as well to the uniformity of employment agreements that develop between individual workers and firms in countries (primarily in Western Europe) with antidischarge legislation (Bain 1992).

However, this diversity of explicit individual employment contracts appears quite consistent with economists' notions of implicit contracting in the labor market and with psychologists' concepts of psychological contracting in the employment relationship. Absent active institutions, such as labor unions, works councils, or employee rights legislation, in the structuring of explicit individual employment contracts, the provisions of such contracts can be expected to vary according to the characteristics of firms, the preferences of management, and the characteristics and preferences of employees. Indeed, this is consistent with the previously observed

variation in the scope of terms and conditions included in explicit individual contracts, with the variation in the proportion of firms' employees covered by such contracts, and, most basically, with the fact that such contracts exist in some but not other firms.

Nevertheless, perhaps the most interesting question about explicit individual contracting in the labor market is whether or not it will become more dominant or fade from the scene in the years ahead. This question is taken up next, using the evidence presented here as a point of departure.

The Future of Explicit Contracting

Assuming that the data obtained from the sample of firms included in the UCLA survey can be generalized to the business sector as a whole, it appears that a larger proportion of the U.S. work force is presently covered by explicit individual employment contracts than by collective bargaining contracts — roughly 24 percent versus 13 percent. Thus, to a substantial extent, explicit individual contracting has supplanted explicit collective contracting in the U.S. labor market, and the differential incidence of these two contractual forms may widen if predictions of further decline in the unionization of the U.S. work force are taken seriously (Freeman and Medoff 1984; Lewin, Mitchell, and Sherer 1992).

The major "unknown" in all of this concerns the potential conversion of implicit or psychological contracts into explicit contracts. What factors may drive such conversion? The empirical findings and case examples presented in this chapter suggest that increased employer use of financial participation programs, information sharing programs, and employee training programs will contribute to a rising incidence of explicit individual employment contracting and to enlarged proportional coverage of employees by such contracts; so too will a rising incidence of employment discrimination and wrongful termination litigation, relative growth of employment in managerial and professional occupations and in the financial services sector, and enhanced multinational operations of U.S. firms.

Conversely, increased employer use of nonfinancial participation and flexible job design programs is likely to be associated with a decline in the incidence of explicit individual employment contracting and in the proportion of employees covered by such contracts. This is because these human resource management initiatives, more than most others, are typically grounded in the concept of

organizational culture, which places strong emphasis on organizational members' "voluntary" (rather than contractual) adherence to a set of core or shared values (O'Reilly 1989). The dominant core value in so-called strong organizational cultures is commitment to the organization (Lawler 1986), and employee nonfinancial participation programs — for example, quality circles, quality-of-working-life improvement schemes, and autonomous work teams — and flexible job and work design programs are intended to enhance such commitment on the part of employees (Cooke 1990). Further, the idea of organizational commitment is closely akin to earlier ideas about attitudes, expectations, and beliefs that stem from the concept of psychological contracting in the employment relationship. And, as in the case of psychological contracting, the members (managers and employees) of "high-commitment" firms characterized by programs of employee nonfinancial participation and flexible job design appear to prefer implicit contracts or shared understandings to explicit individual employment contracts.

However, it is far from certain that the incidence of or employee coverage by nonfinancial participation and flexible job design programs will increase over the next several years. Various threats and challenges to such programs have been identified elsewhere (Lewin 1989b, 1991; Aaron 1992), and perhaps chief among them are the differential "risk preferences" of senior executives and employees with respect to highly participative, flexible work organizations. Employees, or a substantial subset of them, may prefer less participation and flexibility (risk) in work than senior executives who are imbued with enhancing their firms' competitiveness via the development of strong-culture, high-commitment work organizations. Put differently, organizational culture is a mechanism of social control, and as with other such mechanisms employees may prefer less control or to have a formal say in the control process. But just as employees have increasingly been rejecting unionism as a form of workplace participation, they are also likely to reject too much workplace and organizational participation in other forms.[13] Therefore, the apparent dampening effects of employee nonfinancial participation and flexible job design programs on explicit individual contracting in the labor market are unlikely to grow and may well shrink in the next several years.

A more positive case for the growth of explicit individual contracting can be made on the basis of aforementioned initiatives in the areas of employee financial participation, information sharing, and employee training. Firms are increasingly likely to seek more formal arrangements for securing returns on investments in variable pay,

information sharing, training programs, and worker self-monitoring, and employees are increasingly likely to expect that these terms and conditions of employment will be put in writing. Enhanced product market competition and use of human resources to achieve strategic business objectives underly this prediction about firm behavior, while the passing of the era of having a "career with the company," and increased use of formal contracting in other spheres of social and economic life (such as for appliance repair and maintenance, various insurance coverages, and credit card usage) are among the factors underlying this prediction about employee expectations and behavior. These forces, in turn, will produce a higher incidence of explicit individual labor market contracting and a higher proportion of employees covered by such contracting arrangements than presently exist, though changes in the scope of terms and conditions under explicit individual employment contracts are far more problematic and difficult to forecast.

Finally, it is also likely that explicit individual labor market contracting will exhibit a certain dualism, segmentation, or, in Kerr's terminology, "balkanization." The incidence of such contracting is greater — and likely to be greater still — in managerial and professional labor markets than in others; in manufacturing and financial service firms than in others; in firms with highly structured internal labor markets rather than in firms with unstructured or nonexistent internal markets; and in firms with variable pay, information sharing, and training programs than in firms without such programs. Thus, while it would stretch credulity to predict that every firm and every employee will soon be party to explicit individual employment contracts, it is plausible to expect that explicit individual contracting will become the new dominant institutional arrangement in U.S. labor markets during the 1990s.

Notes

1. This is hardly the first time that a common industrial relations idea, issue, or problem has been studied by scholars from different disciplines with little or no cross-fertilization. For a more generalized treatment of this phenomenon, see Kaufman 1989, Lewin 1989a, and Cummings 1989.
2. A 40 percent sample of the roughly 5,500 "business lines" listed in the 1990 Compustat II file was selected for the purpose of administering the explicit contracting survey. The initial mail survey was followed by one written and one telephone follow-up survey, yielding an overall 53 percent response rate.

3. For the unionization, firm size, and firm age variables, the distribution of respondents was split at the mean to create high-low, large-small, and old-young categories, respectively. Geographical scope was measured by the proportion of the firm's work force employed outside the United States. As before, the distribution of respondents was split at the mean to create two categories, in this case, multinational and domestic.
4. Examination of the zero-order correlation matrix for the independent variables used in the regression analysis showed no significant multicollinearity. Because this is an "early stage" study of explicit contracting in the labor market, an argument can be made for retaining all of the theoretically motivated independent variables even in the presence of multicollinearity. It is also because this is an early stage study that formal modeling and hypothesis specification have been deemphasized.
5. In effect, these structural characteristics are treated as control variables in the regression analysis.
6. This multiplicity of measures of explicit individual labor market contracting is closely similar to the multiplicity of measures of strike activity — for example, the number of strikes, the number of workers on strike, and work hours and days lost due to strikes (see Kaufman 1992). As with strikes, an argument can be made that the incidence of labor market contracting is less meaningful than the number or proportion of employees covered by such contracts or the scope of terms and conditions included in such contracts.
7. Six items comprise this scope-of-coverage variable, with a five-point scale used for each item. Hence the explicit contract scope-of-coverage index ranges between 6 and 30. The mean score on this index among respondent firms was 16.5, with a standard deviation of 2.4.
8. The variables MNG-PROF and MFG-FIRE are constructed dichotomous variables, with yes = 1, no = 0.
9. The term *trade secrets* is in fact rarely used in the explicit individual employment contracts that were examined during the course of this study. Instead, these contracts often refer to "proprietary" processes, data, and knowledge.
10. Among the responding firms with explicit individual employment contracts, about 17 percent made reference to personal, nonwork behavior in the case of contracts with managerial personnel, compared with 11 percent in the case of contracts with nonmanagerial personnel. Among the personal, nonwork behaviors mentioned in these contracts were alcohol, drug, and gambling dependency, and physical and mental well-being.
11. The site visits, field interviews, and archival analysis were conducted between August 1990 and October 1991. Three other firms have since agreed to participate in a companion study, which is part of the UCLA Project on Explicit Labor Market Contracting.
12. These provisions include general or industry-specific business conditions necessitating layoffs; the sale or relocation of establishments; and

the employee's personal health, financial considerations, and family circumstances. Basically, Firm H does not press unwilling employees to remain in its employ, and chooses not to attempt legally to enforce its explicit contracts with non-managerial personnel. Still, Firm H believes that the main contribution of explicit contracting is to codify the relationship between company-provided training and the employee's subsequent pay and career progression within the firm.

13. Indeed, employees (or a substantial proportion of them) may regard the concept of a strong organizational culture as an ideology of management that, as with prior ideologies, primarily seeks to retain the authoritative control of management over employees (see, for example, Bendix 1956).

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